IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No.

VIRGINIA NATIONAL BANK,

Petitioner

v.

UNITED STATES OF AMERICA,

Respondent

PETITION OF VIRGINIA NATIONAL BANK FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered in the above-styled case on November 15, 1971.

OPINIONS BELOW

The opinion of the United States District Court for the Eastern District of Virginia, Norfolk Division, John A. MacKenzie, Judge, a copy of which is appended hereto, is reported at 321 F. Supp. 316 (1970).

A copy of the opinion of the United States Court of Appeals for the Fourth Circuit, which has not yet been reported, is appended hereto.

JURISDICTION TO REVIEW

The jurisdiction of this Court is invoked under Section 1254(1) of Title 28 of the United States Code [28 U.S.C. § 1254(1)], on the grounds that the Court of Appeals has not only decided an important question of Federal law which has not been, but should be, settled by this Court, but also has decided said question in a way which is in direct conflict with applicable decisions of this Court (or, if not so in conflict, said decision has, in effect, declared invalid a taxing statute of the State of Virginia). The date and time of entry of the judgment of the Court of Appeals sought to be reviewed is November 15, 1971. An order denying petitioner's request for a rehearing was entered by said Court of Appeals on December 15, 1971.

QUESTIONS PRESENTED

Whether petitioner is entitled, as it contends, in determining its federal income tax liabilities for the years concerned, to deduct, as a tax under Section 164(a) and Section 164(e) of the Internal Revenue Code of 1954, as amended (the "IRC") or as a business expense under Section 162(a) of the IRC, certain payments, made pursuant to the requirements of the tax laws of the State of Virginia, to institutions which were exempt from state property taxation and life insurance companies which were exempt from state intangibles taxes because subject to state tax on gross premium income (all such institutions being defined in the Virginia taxing statute as, and herein sometimes referred to as, "exempt institutions"), which were (or had been) shareholders of the petitioner, or whether such payments were, as the respondent has contended, nondeductible dividends or other distributions with respect to the petitioner's stock.

RELEVANT STATUTES

The Federal statutory provisions which are involved in this case are contained in Sections 162(a), 164(a), 164(e), 301(a) and 316(a) of the Internal Revenue Code of 1954 [26 U.S.C. § 162(a), Vol. 6, p. 6364; 26 U.S.C. § 164(a), Vo 6, p. 6369;

26 U.S.C. § 164(e), Vol. 6, p. 6370; 26 U.S.C. § 301(a), Vol. 6, p. 6436; and 26 U.S.C. § 316(a), Vol. 6, p. 6450] and Section 548 of Title 12 of the United States Code (Revised Statutes, Section 5219; 12 U.S.C. § 548; Vol. 3, p. 2378); as in effect during the years involved, the full text of each of which is set out in the appendix hereto.

The provisions of the Income Tax Regulations involved are Sections 1.162-1(a), 1.164-1, 1.164-3 through paragraph (a) thereof, 1.164-7, 1.301-1 through paragraph (c) thereof and 1.316-1(a)(1) [26 CFR §§ 1.162-1(a), 1.164-1, 1.164-3, 1.164-7, 1.301-1(c) and 1.316-1(a)(1)] the full text of each of which is set out in the appendix hereto.

The provisions of the Virginia statutes which are involved are contained in Chapter 10 of Title 58 (Sections 58-465 et seq.) of the Code of Virginia of 1950 as amended (the "Virginia Code") specifically Sections 58-465, 58-466, 58-470, 58-473 and 58-480, as in effect prior to June 26, 1964, and Section 58-473 and Sections 58-465.2 and 58-480.1 of the Virginia Code as amended and added at the 1964 Session of the Virginia General Assembly, effective on June 26, 1964, the full text of said Chapter and of each of said amended and added Sections being set out in the appendix hereto.

STATEMENT OF THE CASE

The petitioner is a national bank having its principal office in and doing business in the State of Virginia. As the one tax permitted to it by Section 548 of Title 12 of the United States Code (12 U.S.C. § 548; Revised Statutes, Section 5219), the State of Virginia has elected to impose a tax upon the shares of national banking associations located within its limits.

Prior to June 26, 1964, the effective date of the amendments enacted at the 1964 session of the Virginia General Assembly, the state taxing statute contained no express provision relating to shares of banks owned by exempt institutions. However, pursuant to, and since, a 1928 decision

of the Supreme Court of Appeals of Virginia, the State of Virginia has, taking into account other pertinent Virginia constitutional and statutory provisions, taken the position that exempt institutions are entitled to refund to them of any tax paid by a bank with respect to shares owned by such exempt institutions, and has permitted and encouraged banks, in lieu of remitting the tax on such shares to the state, to remit the same amount directly to the exempt institutions concerned and to reduce the amount paid to the state by the amounts so directly paid. If any bank did not make direct remittances to exempt institutions, the State required that the tax on all shares be paid to the State. After June 26, 1964 the state taxing statute was amended to make mandatory such direct payments to exempt institutions.

During all the years involved in this case, the state taxing statute required that each bank make a return, as of the first day of January of each year, and file such return on or before the first day of February of such year with the Commissioner of Revenue of the county or city in which the bank was located. Each bank was required to pay to the state [tax payments made to cities, towns and counties pursuant to said Virginia statute being treated herein as paid to the state], on or before the first day of June of each year, the state tax at the rate of One Dollar ($1.00) on each One Hundred Dollars ($100) of the value of its stock, except that prior to June 26, 1964, each bank was permitted, and after said date required, to make payments directly to such exempt institutions which had owned shares on January 1 of the year involved, at the aforesaid rate, and to reduce the payment to the state by the amounts so directly paid.

In accordance with the Virginia law, the petitioner made the following payments:

	To the State	To Exempt Institutions
1963	$151,584.77	$ 5,629.95
1964	300,846.20	6,148.30

1965	317,286.48	11,421.46
1966	364,712.92	13,637.74

The petitioner made all such payments from amounts accrued and designated as its tax accounts, its Board of Directors never declared a dividend or took any other action with respect to the aforesaid payments; and no exempt institution or other shareholder ever reimbursed the petitioner for any amounts paid under the said Virginia statute. The Virginia taxing statute provides to each bank the right to recover from each shareholder other than an exempt institution the amount paid with respect to such shareholder's shares but does not provide for any right of recovery of payments to exempt institutions. In determining the petitioner's federal income tax liabilities for the years concerned, the petitioner deducted all the payments made as required by the Virginia law. The respondent allowed such deductions for the amounts paid to the state but disallowed deductions for the amounts paid directly to exempt institutions and collected additional federal income taxes on account thereof.

On July 17, 1969, the petitioner brought suit in the United States District Court for the Eastern District of Virginia, Norfolk Division, for refund of federal income taxes and assessed interest thereon in the aggregate amount of Forty-Four Thousand Five Hundred Ninety-Eight Dollars ($44,598.00), which had been collected by the respondent from the petitioner as additional federal income taxes for 1963, 1964, 1965 and 1966, invoking the jurisdiction of said District Court under 28 U.S.C. Sections 1340, 1346(a)(1) and 1402. Said suit originally involved three separate issues but prior to trial the respondent conceded two of said issues, leaving for decision by the District Court only the issue herein presented. With respect to said issue, the petitioner claimed that the payments involved were deductible under Section 162(a) of the IRC as ordinary and necessary business expenses and also under Section 164(a) and (c) of said Code as taxes, while the respondent claimed that the payments were non-deductible dividends or other distributions by

the petitioner to its exempt institution shareholders with respect to petitioner's stock owned by them.

The issue was tried in the District Court, without a jury, upon the pleadings and stipulations of the parties, including depositions, and judgment was awarded to the petitioner in the amount sued for. Of the total amount of said judgment, approximately Twenty-Three Thousand Nine Hundred Twenty Dollars ($23,920.00) (just over 53%) related to the conceded issues and approximately Twenty Thousand Six Hundred Seventy-Eight Dollars ($20,678.00) (something over 46%) related to the issue now presented herein.

The District Court held that the payments in issue were ordinary and necessary business expenses incurred in the carrying on of its banking business and deductible under Section 162(a) of the IRC.

Upon request by the respondent that the District Court also make a finding on whether the payments were a tax, or not, under the appropriate parts of Section 164 of the IRC, the District Court held that such payments were taxes in the context of the facts of this case and were also deductible as such under said Section 164.

On appeal, in a divided opinion, Judge Winter dissenting, the Court of Appeals held that the payments fit the statutory definition of dividends, that the payments were in substance dividends required by state law to be paid by a national bank, and that the payments were not deductible under any provision of the IRC in determining the petitioner's federal income taxes, and, accordingly, reversed the decision of the District Court.

ARGUMENT

The majority opinion of the Court of Appeals reflects an almost complete disregard or lack of understanding of the interplay of the various provisions of the IRC, inter se, as well as a failure to take into account the significance and effect of other

state and federal laws and a failure to abide by the decisions of this Court concerning the IRC and other controlling federal law. The Court of Appeals disregarded the fact that the payments in issue fit every definitional requirements of law as ordinary and necessary business expenses and also as taxes, deemed it wholly immaterial that such payments were compelled by the State of Virginia in its taxing statutes, ignored the numerous decisions of this Court to the effect that neither the State of Virginia nor any other state has any power to impose any obligation upon a national bank other than a tax as permitted by express federal law, and based its decision entirely on Sections 301 (which provides only for the tax effects upon a *recipient* of property distributed by a corporation to its shareholders with respect to its stock) and 316 (which defines a dividend) of the IRC, and upon some wholly unwarranted and immaterial assumptions and reasoning with respect to Virginia law and the purpose and effect of the Virginia taxing statute. In arriving at its conclusions, the Court of Appeals, as is apparent in the first footnote to its opinion, entirely disregarded the last sentence of Section 164(a) of the IRC which had been cited to it by the petitioner as authority for its position, and as the basis for its decision the Court used certain illustrations and reasoning which give no more support to its own decision than to the opposite decision of the District Court.

There are involved here important questions of federal income tax law which have not been, but should be, settled by this Court. This Court has on some occasions addressed itself to the question of whether a particular payment is or is not an ordinary and necessary business expense within the meaning of Section 162(a) of the IRC (and similar provisions of prior law), e.g., *Welch* v. *Helvering*, 290 U.S. 111, but the diverse nature of the many businesses being conducted and the limited nature of the questions presented in any particular case will not permit any one decision which can spell out in detail any single precise test which can be thereafter applied in every case. The basic question is whether, in all the circumstances, the expenditure is

ordinary and appropriate to the conduct of the taxpayer's business. It need only be appropriate and helpful and need not even be habitual or normal in the sense that the same taxpayer will have to make such expenditures often or that they can be reasonably anticipated by a particular taxpayer but only that they are the kind of obligation which would be normal or might be expected to arise in the type of business concerned. Past decisions of lower courts are sometimes helpful to taxpayers and the respondent as illustrative of the principles involved in such a determination but some are (as would be the decision of the Court of Appeals here) confusing and difficult of application. Frequently, at least in the eyes of the respondent, there are no controlling guides. The state of the law is now such that there are insufficient reliable guidelines which are accepted as valid by both taxpayers and the respondent and there continually arises disputes and litigation, as well as different treatment of different taxpayers, all of which should be minimized and avoided if possible. The existing situation will be worsened if the decision of the Court of Appeals herein is not reviewed by this Court.

Frequently the respondent has urged upon the lower courts (and the lower courts have sometimes accepted) unwarranted extensions or variances from the rules set out by this Court, with the result that, in actual application, the law as stated by this Court is not followed. This case is an example. Before the Court of Appeals, the respondent presented this Court's opinion in *Lincoln Savings and Loan Association* v. *Commissioner*, 403 U.S. 345, as holding, and requiring in this and every other case, that any element of compulsion to pay must be completely disregarded. Notwithstanding the statement in the opinion of the Court of Appeals which purports to recognize one of the rules stated by this Court in the *Lincoln* case, i.e., that compulsion does not *per se* make a payment a business expense, it is obvious that the erroneous argument of the respondent was actually adopted by the Court of Appeals, although the error thereof was recognized in the dissenting

Further, there is involved here a decision by the Court of Appeals which is in direct conflict with decisions of this Court respecting the powers of a state over national banks. Since paramount federal law, as stated by this Court on several occasions, forbids any tax or other imposition by a state upon a national bank except as expressly permitted by 12 U.S.C. Section 548, the State of Virginia has no power to require the petitioner to make the payments here involved, and said Virginia statute is void, if such payments are not state taxes as authorized by said federal statute. This Court has also previously indicated, many times, that every part of a statute must be considered in order to determine its true meaning. And every controlling federal statute must be considered in determining the proper meaning and application of a subordinate state statute and, in accordance with the long established rule, a court should indulge itself only in those presumptions which will tend to establish the validity of a state law rather than those which will result in its invalidity. *First Agr. Nat. Bank of Berkshire County* v. *State Tax Commission*, 392 U.S. 339, and the cases therein cited; *Home Savings Bank* v. *Des Moines*, 205 U.S. 503, and the cases therein cited; *Hellmich* v. *Hellman*, 276 U.S. 233. When all the pertinent laws are so considered in this case, it becomes clear that the State of Virginia intended (i) that all obligations imposed by Virginia upon national banks under its tax laws be valid under federal law, (ii) that every national bank in Virginia pay the same amount of tax upon its shares whether or not any of such shares are owned by exempt institutions, and (iii) that the payment procedures adopted by it would provide a convenient method of granting refunds to exempt institutions of the taxes paid by national banks upon shares owned by such exempt institutions. The desirability, on the part of the state, for such procedure for direct refund is obvious since it is less cumbersome and costly to the state, including the local taxing political subdivisions which would otherwise also make a part of each refund to the exempt

institutions. Further, it seems incredible that Congress, in enacting Sections 164(a) and 164(c), would have intended that a bank be entitled to an income tax deduction for state taxes paid by it on shares owned by non-exempt persons when the bank had, but elected not to exercise, the right to reimbursement of such taxes from the shareholder, but be denied a deduction for amounts which the state taxing statute required to be paid to exempt institutions from which the bank could not require reimbursement.

This case probably presents to this Court a greater opportunity than ever before presented in any one case to interpret and clarify the provisions of Sections 162 and 164 of the IRC in a way which will be of immense importance to taxpayers, their advisers, the respondent and the lower courts. On the other hand, if the decision of the Court of Appeals herein is permitted to stand without review by this Court, the difficulty of correctly construing and applying the provisions of the IRC will be greatly increased. Even with respect to factual and legal situations not similar or identical to this case, it is imperative that the questions herein be settled by this Court. The Court of Appeals opinion will undoubtedly be presented in future litigation as standing not only for propositions which have never heretofore been applied or sanctioned but also for some which have been heretofore rejected by the courts, and will, just as surely, be presented as controlling authority against principles of law which have heretofore been generally or universally accepted.

Said opinion casts doubt upon the correctness of numerous Revenue Rulings which have been issued by the Commissioner of Internal Revenue in his administration of the income tax laws.

Research by counsel for the petitioner indicates that twenty other states of the Union impose a tax on shares of national banks, as in Virginia, but it appears that none of the statutes of said twenty other states requires (as Virginia does)

that similar payments be made by national banks to exempt institutions in lieu of direct payment to the state. Counsel has so far been unable to determine which, if any, of said other states permit similar direct payments with a credit against the state tax. Accordingly, it appears that no review by this Court of the federal income tax questions herein presented is likely to arise from a conflict in decisions of such questions among the Courts of Appeal. Yet the determination of the correct federal income tax liabilities of every bank in the State of Virginia, state and national, depends upon a correct decision in this case. Other litigation is in fact presently pending in another division of the United States District Court for the Eastern District of Virginia, involving at least one other national bank, the decision in which will depend upon the final decision here.

It is also imperative that this case be reviewed because of the other, non-income-tax implications of the decision of the Court of Appeals herein. This Court has uniformly held that national banks are subject only to such obligations imposed by the states as Congress expressly permits, that any obligation so permitted may be imposed only to the extent and in the manner authorized, that Congress may prohibit any taxation or other imposition upon national banks by the states and that mere silence by Congress is a prohibition. *First Agr. Nat. Bank of Berkshire County* v. *State Tax Commission*, *supra*. If the payments required by the Virginia taxing statute are not taxes, then one can only conclude that Virginia has exceeded its power in requiring that they be made. [It should be noted that the amendments of 12 U.S.C. 548 made by P.L. 91-156 and P.L. 92-213 do not remove, as to any period after such amendments, any of the questions herein presented.] Not only is serious doubt created as to the power of Virginia to require such payments but also as to the propriety of any action by officials of national banks which permit the payment thereof by the banks. If the required payments are not taxes validly imposed, the officials of a national bank may have no warrant or authority to voluntarily make or permit the making of such

payments, with resulting very serious questions of personal liability if they do so. Any stockholder would undoubtedly have the right to prevent voluntary payments or distributions to shareholders if he were not permitted to share therein. And it is difficult to conceive of any valid argument that any rule of law or any concept of equity or fair play as among shareholders requires that such payments to exempt institutions be made in Virginia when no such law or concept apparently exists in some, and perhaps all, of twenty other states.

Yet, in view of the penalty provided for in the Virginia statute for failure of a bank to comply with the statutory provisions, or if an exempt institution should insist upon the payments provided for in the statute, bank officials may be compelled to seek court guidance before making or failing to make such payments. A logical consequence, then, of the decision of the Court of Appeals would be the institution of one or more suits or actions to squarely put before a court or courts the question of the validity of Section 58-480.1 of the Virginia Code, which at the very least has now been put in grave doubt, with the result that the question will most likely be presented to this Court for final decision. If the statute is subsequently held to impose a valid tax, it will be of no great comfort to the petitioner and other banks in the State of Virginia that their position has been upheld as to the deductibility of such payments for income tax purposes since they will have already been denied valid deductions for valid taxes in computing their federal income tax liabilities for all closed years. Conversely, if the Virginia taxing statute is held to be invalid, the petitioner and other banks in Virginia will not thereafter be entitled to income tax deductions [the rationale of the Tax Court's decision in *Denise Coal Co.* v. *Commissioner*, 29 T.C. 528, would still permit deductions for periods prior to the final determination of invalidity of the Virginia statute] because they will not be required to make any further such payments under said Virginia statute, but such a holding would not remove any of the aforementioned questions respecting the

propriety of the payments theretofore made and would leave unresolved the further question as to whether refunds thereof may, or must, be required from the exempt institutions.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

/s/ T. Howard Spainhour
Attorney for the Petitioner

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

Norfolk Division

CIVIL ACTION
No. 348-69-N

VIRGINIA NATIONAL BANK,

Plaintiff

v.

UNITED STATES OF AMERICA,

Defendant

MEMORANDUM OPINION

Appropriately proceeding under the proper federal statute, the Commonwealth of Virginia has imposed a tax on the holders of the shares of stock of any bank doing business in Virginia.

Upon receipt of the list of stockholders and the number of shares held by each, the Commissioner of the Revenue assesses upon each such holder the tax provided in the statute and makes returns of this assessment to the State Department of Taxation and to the Bank. By statute, the Bank is then required to pay the tax thus assessed against the shareholders directly into the State Treasury.

The tax is not assessed against the shares of stock held by exempt institutions, and the statute specifically directs that at the same time the Bank pays the stockholders' tax into the State Treasury, it shall pay directly to the exempt shareholder ". . . a sum equal to the tax which would otherwise have been paid . . ." etc.

Acting pursuant to these statutory directions, the Virginia National Bank paid the shareholders' tax for the taxable years

1963, 1964, 1965, and 1966, and, as required, remitted to exempt shareholders, an amount equal to the tax, for the same years.

The Bank claimed all such payments as deductions. The Internal Revenue Service allowed the deduction as to non-exempt shareholders, but did not allow the deduction for the sums paid to exempt shareholders.

Payment of the Internal Revenue Service assessment was made and this suit for refund followed.

The issue is a comparatively narrow one - namely:

(1) Are such payments to exempt shareholders deducted as either "taxes" or "business deductions," as contended by the Bank?

(2) Are such payments non-deductible corporate distributions to shareholders as the Government contends?

FINDINGS OF FACT

(1) Plaintiff, Virginia National Bank, a national banking institution, doing business in Virginia is subject to State taxation by Virginia, under authority of 12 U.S.C. § 548, when the tax is levied in accordance with that statute.

> "The legislature of each State may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits . . ." 12 U.S.C. § 548.

(2) Pursuant to such authority, Virginia has caused to be enacted under Chapter 10 of Title 58 of the Code of Virginia, 1950, as Amended, as Sections 58-465, et seq., in pertinent part as follows:

> "§ 58-465. Meaning of the word 'bank' as used in this chapter.— For the purposes of this chapter the word 'bank' shall mean any . . . bank, . . . organized by or

under the authority of the laws of the United States, doing business . . . in this State; . . .

"§ 58-465.2. Meaning of 'exempt institution'.— For the purposes of this chapter the term 'exempt institution' shall mean any . . . institution (a) the property of which is exempt from taxation under § 183 of the Constitution of Virginia . . . [my note: public buildings, churches, charitable institutions, etc.] . . . or (b) an insurance company which pays a State license tax on gross premium income . . . which owns the shares of any bank . . .

"§ 58-466. Bank capital not assessable; stockholders taxed.— No tax shall be assessed upon the capital of any bank but the stockholders in such banks shall be assessed and taxed on their shares of stock therein.

"§ 58-473. Rate of taxation of bank stock; assessment; certain shares exempt; to whom lists sent.— The commissioner of the revenue as soon as he receives the report mentioned in § 58-470 [my note: list of stockholders and shares held by each] shall assess upon each stockholder . . . a tax at the rate of one dollar on each one hundred dollars of such value of such stock. No such tax shall be assessed in respect to shares owned by exempt institutions . . .

"§ 58-480. Time and manner of payments by banks or taxes assessed against stockholders, receipts therefor.— Every bank. . . . shall pay into the State treasury the State taxes assessed against its stockholders . . .

"§ 58-480.1. Payments by banks to exempt institutions and bank holding companies held by exempt institutions.— Each bank, at the time it makes the payments required by § 58-480, shall pay to those of its stockholders which are exempt institutions . . . a sum equal to the tax which would otherwise have been paid . . ."

(3) Acting under § 58-465, et seq., Code of Virginia, 1950, as Amended, Virginia National Bank, made the following payments for the years in suit:

	Payments of taxes made directly to the Commonwealth of Virginia	Amounts paid to Tax Exempt Institution Shareholders as required by Virginia Statute
1963	$131,584.77	$ 5,629.95
1964	$300,846.20	$ 6,148.30
1965	$317,286.48	$ 11,121.46
1966	$364,712.92	$ 13,637.74

Taxes were computed according to the number of shares owned by each shareholder, and a check prepared on behalf of that shareholder for such tax and forwarded by the Bank to the Treasurer of Virginia. Equivalent checks were drawn by the Bank and sent to exempt shareholders with a letter that the Bank was sending to them, as required by law, the tax that the Bank would otherwise pay to the State of Virginia.

In this latter case, it is noteworthy that formerly these payments to statutory exempt institutions, like the shareholders' tax payments, could be made directly to the Treasurer of Virginia who, in turn, would make the final remittance to the exempt institutions. A 1964 Amendment to the State law did away with the necessity of this payment into the State, and its payment out, and directed the Bank to pay directly to the exempt institution.

(4) Virginia National Bank deducted on its tax returns for the years in suit all of the payments required of it by State law, § 58-465, et seq., i.e., both to the State of Virginia and to exempt institutions, as taxes, under either Section 164(a) or Section 164(c), or as ordinary and necessary expenses under Section 162 of the Internal Revenue Code of 1954.

(5) The Government disallowed the deductions by the Bank for sums paid by it to exempt institutions, and claims that such payments constitute non-deductible corporate distribu-

tions to shareholders.

(6) The disputed taxes were paid by the Bank, a refund was timely claimed and this suit for refund has been timely filed. This Court has jurisdiction under Title 28 U.S.C. § 1346(a)(1). The venue and parties are proper.

(7) It is stipulated that no dividend is declared to cover the amounts paid to the Treasurer of Virginia or forwarded to the exempt institutions and that no shareholder reimburses Virginia National Bank for any taxes paid under the Virginia Statute.

CONCLUSIONS OF LAW

(1) The quick answer to the problem posed here is that the payments made by Virginia National Bank to its shareholders which are exempt institutions are ordinary and necessary business expenses incurred in the carrying on of its banking business and deductible under Section 162(a) of the Internal Revenue Code of 1954.

Certainly the Virginia statute which makes such payments absolutely mandatory likewise makes such payments "necessary." These payments are likewise required to be paid annually by June 1st of each year, have been for many years, and are "ordinary" business expenses. The argument that the payments are made to shareholders who are not "creditors," runs counter to the record. A shareholder, entitled to such payment from the Bank, which in turn has no choice but to pay under the mandate of a State statute, is surely a creditor in every sense of that word, with the right to sue to collect.

The payment by the Bank and the right of the exempt shareholder to receive it is a legal obligation far surpassing the requirements (which need not be a legal obligation) to allow it to qualify as an "ordinary" and "necessary" business expense.

Waring Products Corporation v. *Commissioner*, Tax Court, March 12, 1957, 27 T.C. 921. As stated in *Waring*, supra, "The basic question is whether, in all the circumstances, the expenditure is ordinary and appropriate to the conduct of the taxpayer's business." See also: *Champion Spark Plug Co.* v. *Commissioner*, Tax Court, May 15, 1958, 30 T.C. 295, Affirmed 266 F.2d 347 (6th Cir., 1959).

(2) For appellate purposes, the Government requests that this Court make a finding on whether the payment made to exempt institutions by Virginia National Bank is a "tax," or not, under the appropriate parts of Section 164 of the Internal Revenue Code of 1954.

While perhaps not necessary for decision - nevertheless for the purpose of the record on review, the Court, further, is of the opinion that even if such payments were not necessary and ordinary, business expenses and thus deductible on that score, that such payments also qualify as "taxes" in the context of the facts of this case, and would be deductible under this alternative, for these reasons:

(a) The payment of both the tax on shareholders into the State Treasury and the payment to exempt-institution shareholders, is found in the same taxing Statute of Virginia, § 58-465, et seq.

(b) The payment exacted is made absolutely mandatory with no options to the Bank, in the same taxing statute.

(c) The rate for fixing the amount to be paid is the same in both cases and is fixed by the same taxing statute.

(d) The total mandatory payment to be made by the Bank is the same, no matter what fluctuation may occur in stock ownership. The only change in the total required to be paid by the Bank is dictated only by change in value, not upon the ownership of the stock.

(c) Both payments could formerly be made in toto, to the State Treasurer, arguable, at least, as evidence of a tax. The 1964 amendment did not change the Bank's obligation to pay, but merely added an additional expense and duty on the Bank in requiring its remittance to be made directly to the exempt-institution shareholder.

As the Court views it, the per share tax on shareholders is nonetheless a *tax* remitted, when paid to a church or to an otherwise exempt institution such as a life insurance company. The basis for the remittance in the latter case is that the life insurance company in Virginia, by statute, is taxed solely upon its gross premium income, real estate and intangible personal property, "in lieu of all other taxes" (§ 58-500, Code of Virginia, 1950, as Amended). Hence the remittitur of the per share levy is allowed on the payment by the exempted company of its gross premium income, real estate and personal property tax" . . . in lieu of all other taxes" (§ 58-500). In other words, if this bank share levy is not a tax, the insurance company would not be exempted from its payment.

It seems clear, first, that the total obligation imposed by the State upon each Bank in Virginia has always been that each such Bank pay the prescribed tax on all of its shares, and second, that the payment procedures adopted (initially, that the taxes on shares owned by exempt-institution shareholders could be paid to the State for remittance, and, subsequently, that such tax be remitted directly to such shareholder) were designed and intended merely to provide a convenient method of refund, while still imposing upon the Bank the duty to pay the same aggregate amount of tax regardless of who owned the shares.

Assume for a purpose of illustration that all shares of a bank were owned one year by an exempt charity, and the bank properly remitted the tax to such exempt charity. In such case, in the Government's view, it would not be entitled to deduct on the bank tax return the sum so paid. Assume that the next year

shares were sold by the exempt charity to an individual, then upon the payment of the very same sum as in the former year - now paid to the State, would be a proper deduction. In this example the Bank has paid the identical sum in each year - has no control over the negotiation or ownership of its stock - and yet, the Internal Revenue Service reached opposing results over such payments in the two example years. This Court does not believe the law and regulations should be so interpreted.

The Government cites *United States* v. *Butler*, 297 U.S. 1 (1936) as its chief authority in arguing that the payment to exempt-institution shareholders cannot be termed a "tax." The Court is of the opinion that this reliance is ill-placed.

United States v. *Butler*, supra, was testing the constitutionality of the "processing" levy under the Agricultural Adjustment Act. The Court, in a 4 to 3 decision, attempted to follow the revenue derived from the tax and to question its use by the Government as beyond the powers of Congress. In the instant case, the State bank share tax is not attacked as being in some posture an exaction constitutionally impermissible or that it is ultimately misspent by the State. The Court is only concerned in the instant case with the procedural handling of the refunding of the results of a tax which is correctly assessed under authority of a Federal Statute (12 U.S.C. § 548) many times tested and found proper.

In fact, *United States* v. *Butler*, supra, was about the last test of the "New Deal" legislation in the mid-30's, and the "processing tax" proved to be the straw the Court attacked to rule that it was an usurpatory economic regulation lurking behind the form of an otherwise valid revenue measure. The cases are clearly distinguishable.

In the Court's view, the deduction by Virginia National Bank of payments made to exempt-institution shareholders is allowable as a "tax" deduction.

As this Court understands it, some minor computation remains to determine the amount of refund due to Virginia

National Bank, and assumes that this can be appropriately handled by counsel. If not, further recourse to this Court for that determination shall be had if no agreement is reached within sixty (60) days.

Counsel for the plaintiff will prepare a proper Order in accord with this Memorandum Opinion.

/s/ John A. MacKenzie
United States District Judge

Norfolk, Virginia
October 9, 1970

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

NORFOLK DIVISION

VIRGINIA NATIONAL BANK,)
Plaintiff)

v.) CIVIL NO. 348-69-N

UNITED STATES OF AMERICA,)
Defendant)

JUDGMENT

The above-captioned case came on for hearing upon a full stipulation with respect to the issue involving plaintiff's payments to its tax-exempt shareholders, defendant having conceded the remaining two issues; This Court having filed a memorandum opinion on October 9, 1970, now as a result of all of the foregoing, it is hereby

ORDERED, ADJUDGED AND DECREED that plaintiff Virginia National Bank recover from defendant United States of America the sum of $41,713.69 in taxes and $2,884.31 in assessed interest, for a total of $44,598, plus statutory interest as allowed by law.

Dated this 13th day of November, 1970.

/s/ John A. MacKenzie
JOHN A. MACKENZIE
UNITED STATES DISTRICT JUDGE

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 71-1317

Virginia National Bank,

Appellee,

versus

United States of America,

Appellant.

Appeal from the United States District Court for the Eastern District of Virginia, at Norfolk. John A. MacKenzie, District Judge.

(Argued October 5, 1971 Decided November 15, 1971.)

Before HAYNSWORTH, Chief Judge, and WINTER and CRAVEN, Circuit Judges.

David English Carmack, Attorney, Tax Division, Department of Justice, (Johnnie M. Walters, Assistant Attorney General, Fred B. Ugast, Acting Assistant Attorney General, Meyer Rothwacks, Thomas L. Stapleton, Attorneys, Tax Division, Department of Justice, and Brian P. Gettings, United States Attorney, and William T. Mason, Jr., Assistant United States Attorney, on brief) for Appellant, and T. Howard Spainhour (Kaufman, Oberndorfer and Spainhour on brief) for Appellee.

CRAVEN, Circuit Judge:

Virginia law requires national banks to pay to the State a

tax on shares of bank stock ($1 on each $100 share certificate) assessed against their stockholders. Title 58, Code of Virginia, ch. 10, § 58-165 *et seq.* Some stockholders (among whom are charities and insurance companies) are exempted from the tax. The banks are required by the State to pay directly to these exempt stockholders an amount equal to the tax that would be assessed against them were they not exempt. Title 58 Code of Virginia, ch. 10, § 58-180.1. Virginia National Bank, taxpayer in the present case, brought suit in the United States District Court for the Eastern District of Virginia for refund of federal income taxes, claiming that the payments to exempt shareholders made during 1963 ($53,629.95), 1964 ($6,145.30), 1965 ($11,121.16), and 1966 ($[illegible]637.74) were deductible as taxes under 26 U.S.C.A. § 164(a)(1)-(2),[1] or 26 U.S.C.A. § 164(c),[2] or as ordinary and necessary business expenses under 26 U.S.C.A. § 162(a).[3] The government claims that the payments

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1. § 164. Taxes.

(a) General rule. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

* * * * *

2. (c) Taxes of shareholder paid by corporation. Where a corporation pays a tax imposed on a shareholder on the interest of a shareholder, and where the shareholder does not reimburse the corporation, then

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

3. § 162. Trade or business expenses.

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .

are nondeductible dividends under 26 U.S.C.A. §§ 301(a), (c),[4] 312(a),[5] and 316(a).[6] The district court held that the payments are ordinary and necessary business expenses and, alternatively, that the payments are taxes. We hold the payments are nondeductible dividends, and reverse.

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4. § 301. Distributions of property.

(a) In general. Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * *

(c) Amount taxable. In the case of a distribution to which subsection (a) applies

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

5. § 312. Effect on earnings and profits.

(a) General rule. Except as otherwise provided in this section, the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of

(1) the amount of money.

* * * *

6. § 316. Dividend defined.

(a) General rule. For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in the subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

With exceptions not pertinent here, sections 301 and 316 of the Internal Revenue Code contemplate that distributions out of earnings and profits made by a corporation to shareholders with respect to stock shall be taxable to the shareholders as dividends. *Nickerson Lumber Co. v. United States*, 214 F. Supp. 87, 91 (D. Mass. 1963). Whether payments are dividends depends upon the substance of the transaction. *Id.* at 92. The required payments to the exempt stockholders here fit the statutory definition of "dividends." Under Section 316, "every distribution is made out of earnings and profits to the extent thereof."[7] The Virginia statute requiring these payments simply effectuated and directed a small partial distribution of earnings and profits. The effect of, and presumably the purpose of, the payments to the exempt stockholders is simply to put the impact of the bank share tax on nonexempt shareholders alone. Were the payments to exempt shareholders not required, the result would be a diminution of the common source of funds out of which dividends could be paid by the amount of tax assessed against the nonexempt stockholders. If the remainder of the money available for dividends was then equally distributed among all stockholders, the result would be that tax exempt shareholders would have actually paid a share of the tax, *i.e.*, such an exempt stockholder would receive a smaller dividend than if there was no such tax diminishing the fund.[8] On the other hand, if the required payments *and* the amount of the tax are subtracted from the fund available for dividends before the fund is distributed equally among all stockholders,

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7. The bank does not claim a capital distribution.

8. Suppose the bank has 100 exempt stockholders (each owning one share), 100 nonexempt stockholders (each owning one share), and a $5,000 source out of which to pay dividends. The state tax is $1 per share. The bank will subtract from the $5,000 the state tax on the nonexempt stockholders (which the bank must pay to the State), leaving $4,900 to be distributed as dividends. Each of the 200 stockholders will receive a dividend of $24.50. Because each exempt stockholder has received $0.50 less than he would have received in the absence of a tax ($5,000 divided by 200 equals $25), he in effect has paid a tax of $0.50.

the required payments to exempt stockholders plus the normal dividend received by all stockholders equal the portion of the dividend fund the exempt stockholders would have received in the absence of the tax.[9] The payments to the exempt stockholders are in substance dividends required by state law to achieve true exemption. We think such payments were made with respect to stock "to the shareholder in his capacity as such" in the clarifying language of Treas. Reg. § 1.301-1(c) (1971).

The compulsory nature of the payments does not per se make the in-business expenses under section 162. *Commissioner v. Lincoln Savings & Loan Ass'n.*, 403 U.S. 345 (1971). We agree with the government, moreover, that a distribution by a corporation of its own earnings and profits to its own stockholders as stockholders cannot be considered a cost of doing business. See *Sued Distributing Co. v. Commissioner*, 323 F.2d 480 (5th Cir. 1963).

That the bank shares owned by insurance companies cannot be exempted from taxation under section 183 of the Virginia Constitution does not transform payments made to insurance companies into taxes paid by the bank (§ 164(a)) or imposed upon the exempt stockholders (§ 164(c)). The *license* tax on the insurance companies' income includes the amount of tax that would be due on the bank shares but for the statutory exemption; if the license tax does not equal or exceed the bank

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9. Suppose the bank has 100 exempt stockholders (each owning one share), 100 nonexempt stockholders (each owning one share), and a $5,000 source out of which to pay dividends. The state tax is $1 per share. The bank will subtract from the $5,000 the state tax on the nonexempt stockholders (which the bank must pay to the State) and the amount of tax that would be assessed against the nonexempt stockholders but for the exemption, leaving $4,800 to be distributed as dividends. Each of the 200 stockholders will receive a dividend of $24. In addition each exempt stockholder will receive $1, the amount of tax that would have been paid in his behalf were he not exempt. Each exempt stockholder has received $25, what he would have received in the absence of a tax ($5,000 divided by 200 equals $25), and, therefore, remains truly exempt from the state tax.

share tax, the companies apparently would have to pay the difference between the license tax and what the bank share tax would be. Title 58 Code of Virginia, ch. 11, § 58-500. The payments made by the bank to the insurance companies in effect reimburse the companies for the amount of bank share taxes paid by the companies included in the license tax. The license tax, however, was paid by the insurance companies and not by the bank, so that the payments, even if taxes, could not be deducted by the bank under section 164(a). The payments, furthermore, are not "taxes" imposed upon the exempt stockholders under section 164(e). The payments assured that the insurance companies would not pay the bank share tax twice by bearing part of the tax imposed upon the nonexempt stockholders in the form of smaller dividends. The fact that the exempt insurance companies might have to remit to the State some of the payments (in the event that their license tax is not equal to or more than the bank share tax would have been) does not turn the payments into taxes. The payments are simply a source of income to the insurance company stockholders out of which a tax *might* be paid.

Nor does the fact that a tax is the only obligation that may be imposed upon a national bank by a state convert these payments into taxes. *See* 12 U.S.C.A. § 548 (conferring authority upon the states to tax national bank shares). The required payments are merely incidental to the taxation of the nonexempt stockholders; the Virginia statute requiring the payments directs the division of the fund out of which the bank share tax and dividends are paid to assure that the tax imposed upon the nonexempt stockholders will be borne entirely by them.

Reversed and remanded for recalculation of the judgment in accordance with this opinion.[10]

REVERSED AND REMANDED.

10. The judgment of the district court granted a refund to taxpayer of federal income taxes of $44,598, plus interest. According to taxpayer's brief, the issue on appeal involves approximately 45 percent of the entire amount of the judgment.

WINTER, Circuit Judge, dissenting:

I dissent. As the district judge in his memorandum opinion correctly demonstrated, the distributions to exempt stockholders were ordinary and necessary expenses paid during the taxable year in carrying on the bank's trade or business within the meaning of 26 U.S.C.A. § 162(a). Accordingly, they should be deductible as ordinary and necessary business expenses.

Commissioner v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), and *Sneed Distributing Co.* v. *C.I.R.*, 323 F.2d 480 (5 Cir. 1963), are not to the contrary. By no stretch of the imagination can it be said that the distributions to the exempt stockholders constituted a benefit to the bank or an additional capital asset, the basis of decision in *Lincoln Savings*. Nor is there in the instant case the identity of interest present in *Sneed Distributing Co.* that would require the compulsory nature of the payment to be disregarded for federal tax purposes.

I would affirm the district court to the extent that it held the distributions deductible as ordinary and necessary business expenses.

JUDGMENT

UNITED STATES COURT OF APPEALS
for the
FOURTH CIRCUIT

No. 71-1317.

Virginia National Bank,

Appellee,

v.

United States of America,

Appellant.

Appeal from the United States District Court for the Eastern District of Virginia.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Virginia, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be and the same is hereby reversed; and the case is remanded to the United States District Court for the Eastern District of Virginia, at Norfolk for recalculation of the judgment in accordance with this Court's opinion filed herewith.

/s/ SAMUEL W. PHILLIPS
Clerk

FILED
Nov. 15, 1971
SAMUEL W. PHILLIPS
CLERK

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 71-1317

Virginia National Bank,

Appellee,

versus

United States of America,

Appellant.

ORDER

Upon careful consideration of the petition for rehearing, with the concurrence of Judge Haynsworth, the petition is denied. Judge Winter would grant the petition to rehear and adheres to his dissent.

/s/ J. Braxton Craven, Jr.
United States Circuit Judge

Section 162(a) of the IRC (26 U.S.C. § 162(a)) provides, in pertinent part, as follows:

> (a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
>
> (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> [The last sentence of Section 162(a) deals with the residences of members of Congress, and is not pertinent here.]

Section 164(a) of the IRC (26 U.S.C. § 164(a)), as in effect during 1963, provided, in pertinent part, as follows:

> (a) GENERAL RULE.—Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year:
>
> [Subsection (b) set out certain exceptions (i.e., taxes which were not deductible) but none of such exceptions apply to the taxes here in issue.]

Section 164(a) of the IRC was amended, effective on

January 1, 1964, and has thereafter provided, in pertinent part, as follows:

> (a) GENERAL RULE.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (1) State and local, and foreign, real property taxes.
>
> (2) State and local personal property taxes.
>
> (3) State and local, and foreign, income, war profits, and excess profits taxes.
>
> (4) State and local general sales taxes.
>
> (5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.
>
> In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).
>
> [Subsection (b) was concurrently amended and has thereafter provided certain definitions and special rules, none of which are pertinent here.]

Section 164(e) of the IRC (26 U.S.C. § 164(e)), provides as follows:

> (e) TAXES OF SHAREHOLDER PAID BY CORPORATION.—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—
>
> (1) the deduction allowed by subsection (a)

shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

Section 301(a) of the IRC (26 U.S.C. § 301(a)) provides as follows:

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

Section 316(a) of the IRC (26 U.S.C. § 316(a)) provides as follows:

(a) GENERAL RULE.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

12 U.S.C. 548 (Revised Statutes, Section 5219) provides as follows:

§ 548. State taxation

The legislature of each State may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several States may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with:

1. (a) The imposition by any State of any one of the above four forms of taxation shall be in lieu of the others, except as hereinafter provided in subdivision (c) of this clause.

(b) In the case of a tax on said shares the tax imposed shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such State coming into competition with the business of national banks: *Provided*, That bonds, notes, or other evidences of indebtedness in the hands of individual citizens not employed or engaged in the banking or investment business and representing merely personal investments not made in competition with such business, shall not be deemed moneyed capital within the meaning of this section.

(c) In case of a tax on or according to or measured by the net income of an association, the taxing State may, except in case of a tax on net income, include the entire net income received from all sources, but the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing State upon mercantile, manufacturing, and business corporations doing business within its limits: *Provided, however* That a State which imposes a tax on or according to or measured by the net income of, or a franchise or excise tax on, financial, mercantile,

INCOME TAX REGULATIONS

1.162-1 Business expenses.

(a) In general. [illegible]

as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels. In addition, there shall be allowed as a deduction under this section State and local, and foreign, taxes not described in subparagraphs (1) through (5) of this paragraph which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). For example, dealers or investors in securities and dealers or investors in real estate may deduct State stock transfer and real estate transfer taxes, respectively, under section 164, to the extent they are expenses incurred in carrying on a trade or business or an activity for the production of income. In general, taxes are deductible only by the person upon whom they are imposed. However, see § 1.164-3 in the case of certain taxes paid by the consumer.

(b) Taxable years beginning before January 1, 1964. For taxable years beginning before January 1, 1964, except as otherwise provided in §§ 1.164-2 through 1.164-8, inclusive, taxes imposed by the United States, any State, territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. For this purpose, postage is not a tax and automobile license or registration fees are ordinarily taxes.

§ 1.164-8. Definitions and special rules.—For purposes of

section 164 and § 1.164-1 to § 1.164-8, inclusive.

(a) *State or local taxes.* A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

§ 1.164-7 Taxes of shareholder paid by corporation

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

§ 1.301-1 Rules applicable with respect to distributions of money and other property

(a) General. Section 301 provides the general rule for treatment of distributions on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock. The term "property" is defined in section 317(a). Such distributions, except as otherwise provided in this chapter, shall be treated as provided in section 301(c). Under section 301(c), distributions may be included in gross income, applied against and reduce the adjusted basis of the stock, treated as gain from the sale or exchange of property, or (in the case of certain distributions out of increase in value accured before March 1, 1913) may be exempt from tax. The amount of the distributions to which section 301 applies is determined in accordance with the provisions of section 301(b). The basis of property received in a distribution to which section 301 applies is determined in accordance with the provisions of section 301(d). Accordingly, except as otherwise provided in this chapter, a distribution on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent the amount distributed is

considered a dividend under section 316. For examples of distributions treated otherwise, see sections 115(c), 301(c)(2), 301(c)(3)(B), 301(c), 302(b), 303, and 305. See also part II relating to distributions in partial or complete liquidation, part III relating to corporate organizations and reorganizations, and part IV relating to insolvency reorganizations, subchapter C, chapter 1 of the Code.

(b) Time of inclusion in gross income and of determination of fair market value. A distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. However, if such distribution is a distribution other than in cash, the fair market value of the property shall be determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includible in gross income. For example, if a corporation distributes a taxable dividend in property the adjusted basis of which exceeds its fair market value on December 31, 1955, on December 31, 1955, which is received by or unqualifiedly made subject to the demands of its shareholders on January 2, 1956, the amount to be included in the gross income of the shareholders will be the fair market value of such property on December 31, 1955, although such amount will not be includible in the gross income of the shareholders until January 2, 1956.

(c) Application of section to shareholders. Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.

§ 1.316-1 Dividends.

(a) (1) The term "dividend" for the purpose of subtitle A of the Code (except when used in subchapter L, chapter 1 of the Code, in any case where the reference is to dividends and similar distributions of insurance companies paid to policy

holders as such) comprises any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(i) Earnings and profits accumulated since February 28, 1913, or

(ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

STATE STATUTES

Chapter 10 of Title 58 (Sections 58-465 through 58-[illegible]) of the Code of Virginia of 1950, as in effect prior to 1964:

§ **58-465. Meaning of word "bank" as used in this chapter.**—For the purposes of this chapter the word "bank" shall mean any incorporated bank, banking association or trust company organized by or under the authority of the laws of this State and any bank or banking association organized by or under the authority of the laws of the United States, doing business or having an office in this State or having a charter which designates any place within this State as the place of its principal office, whether such bank or banking association be authorized to transact business as a trust company or not, and any joint stock land bank or any other bank organized by or

under the authority of the laws of the United States upon the stock of which this State is authorized to impose a tax. The word "bank" as used in this chapter shall exclude all corporations organized under the laws of other states and doing business in this State; it shall exclude corporations organized not as banks under the laws of this State and it shall exclude all natural persons and partnerships.

§ 58-466. **Bank capital not assessable; stockholders taxed.**—No tax shall be assessed upon the capital of any bank but the stockholders in such banks shall be assessed and taxed on their shares of stock therein.

§ 58-467. **Shares held by another bank not taxable.**—No taxes shall be extended on such shares of stock issued by a bank organized under the laws of this State as are owned by any other bank in this State, whether organized under the laws of the United States or under the laws of this State; but the value of such shares of stock so exempt from taxation in the hands of the bank owning the same shall nevertheless be included in the capital, surplus and undivided profits of the bank owning the stock, for the purpose of assessing its stockholders.

§ 58-468. **Preferred stock owned by Reconstruction Finance Corporation.**—No tax shall be assessed or paid on the shares of any preferred stock issued by any bank in this State sold to the Reconstruction Finance Corporation while owned and held by it.

§ 58-469. **Banks in liquidation.**—When the affiars of any such bank as is mentioned in this chapter are being wound up under the provisions of §§ 6-114 and 6-116 the assets of such bank so being wound up shall continue to be and constitute the capital of such Bank and no tax shall be assessed thereon as such capital. Returns of such assets as of January first of each year shall be made up by those having actual custody or control thereof as the same are held and the commissioner of the

revenue shall assess the tax thereon against those holding such fund at the rate provided for the taxation of money and such assessment shall as to such funds be in lieu of all taxes against those beneficially interested therein; but if any surplus shall remain after payment of depositors and creditors in full, such surplus, together with the names and residences of the stockholders and the number of shares owned by them, respectively, shall then be reported by the liquidating officer to the commissioner of the revenue, who shall ascertain the fair market value of such surplus assets and assess against each stockholder in such bank for each year for which no tax on stock has been paid a proportionate tax on such surplus at the rate prescribed in § 58-473 and such tax shall be paid by the liquidating officer into the State treasury before any distribution of such surplus to stockholders.

§ 58-470. **Report of stockholders by bank.**—Each bank aforesaid, as of the first day of January in each year, shall make up and return to the commissioner of the revenue of the county or city in which the bank is located, a report in which shall be given the names and residences of all its stockholders and the number and actual value of the shares of stock held by each stockholder. Such report shall be filed with the commissioner of the revenue on or before the first day of February of each year.

§ 58-471. **Determination of value of shares of stock.**—From the total value of the shares of stock of any such bank, which shall be ascertained by adding together its capital, surplus and undivided profits, there shall be deducted the assessed value of its real estate otherwise taxed in this State, or if the title to any real estate is held in the name of a holding corporation in which such bank owns all or a majority of the common stock and such real estate be otherwise taxed in this State, then there shall be deducted from the value of the shares of stock of such bank, such proportion of the assessed value of such real estate as the common stock it owns in such holding corporation bears to the whole issue of common stock in such corporation; and

the actual value of each share of stock shall be its proportion of the remainder.

§ 58-472. **Owners entitled to no deductions.**—The owners of the shares of stock of such bank shall be entitled to no deduction from the taxable value of their shares because of the personal indebtedness of such owners or for any other reason whatever.

§ 58-473. **Rate of taxation of bank stock; assessment; to whom lists sent.**—The commissioner of the revenue as soon as he receives the report mentioned in § 58-470 shall assess upon each stockholder upon the taxable value of the shares of stock owned by him a tax at the rate of one dollar on each one hundred dollars of such value of such stock. Such tax shall be in lieu of all other taxes whatsoever for State, county or local purposes upon such share of stock. The commissioner of the revenue shall certify three assessment lists, transmit one to the Department of Taxation, one to the bank and retain one.

§ 58-474. **Assessment list as notice; lien of assessment.**—The assessment list so transmitted to the bank shall be notice to the bank of the tax assessed against its stockholders and each of them and shall have the legal effect and force of a summons upon suggestion formally issued and regularly served. The tax assessed upon each stockholder in the bank shall be the first lien upon the stock standing in his name and upon dividends thereof due and to become due, no matter in whose possession found, and shall have priority over any and all liens by deeds of trust, mortgages, bills of sale or other assignments made by the owner or holder and take priority over all liens by execution, garnishment or attachment process sued out by creditors of the stockholders.

§ 58-475. **Duty of bank.**—The bank shall hold the dividends or other funds belonging to the stockholder and in its custody at the time the assessment list is received or that

thereafter shall come under its control and apply the same to the payment of the tax assessed and when thus applied shall be acquitted and discharged from all liability to the stockholder for the money so disbursed.

§ 58-476. City or town tax on stock.—Any city in this State in which any bank is located and any incorporated town in this State in which any bank is located may, by ordinance, require such bank to deliver to the commissioner of the revenue or other assessing officer of such city or town, a copy of the report which such bank is required by this chapter to furnish to the commissioner of the revenue of the county or city and any such city may impose a tax not to exceed forty per centum of the State rate of taxation on each one hundred dollars of the taxable value of the shares of stock in such banks so located in such city; and any such town may impose a tax not to exceed eighty per centum of the State rate of taxation on each one hundred dollars of the taxable value of the shares of stock in such banks so located in such town; and the commissioner of the revenue, or other assessing officer of such city or town in which such banks are located, shall extend such tax against the stockholders at the rate levied by the council or other governing body of the city or town.

§ 58-476.1. City tax on stock when bank has branch in county; payment to county from State treasury.—Notwithstanding any other provision of this chapter, the tax imposed by any city in this State under § 58-476 on the shares of stock of any bank located in such city, which bank has a branch or branches located in a county without the limits of an incorporated town, shall be on only such proportion of the taxable value of the shares of stock in such bank as the total deposits of the bank, minus the deposits through such branch or branches, bear to the total deposits of the bank as of the beginning of the tax year.

The governing body of any county in which the branch or branches of such bank is or are located may direct the treasurer,

of such county, at any time between June first and December thirty-first of any tax year, to file with the State Tax Commissioner an application for the payment to such county of a sum equivalent to eighty per centum of such proportion of the amount of tax which such bank has paid into the State treasury for that current year on the taxable value of the shares of stock in such bank as the deposits through such branch or branches so located in such county bear to the total deposits of the bank as of the beginning of the tax year. The State Tax Commissioner on receipt of such application if satisfied of its correctness, shall issue an order directing that such payment be made out of the State treasury on warrant of the Comptroller.

§ 58-477. **Town tax on stock when branch bank in town.**—Any incorporated town in this State in which is located a branch of a bank located in any city in this State may, by ordinance; require such bank to deliver to the commissioner of the revenue or other assessing officer of such town, a copy of the report which such bank is required by this chapter to furnish to the commissioner of the revenue of the city and any such town may impose a tax not to exceed forty per centum of the State rate of taxation on each one hundred dollars of such proportion of the taxable value of the shares of stock in such bank whose branch is so located in such town as the deposits through such branch bear to the total deposits of the bank as of the beginning of the tax year. The commissioner of the revenue; or other assessing officer of such town in which such branch is located shall extend the tax against the stockholders at the rate levied by the council or othr governing body of the town.

§ 58-477.1. **When §§ 58.473 to 58-477 in force.**—Sections 58-473 to 58-477 shall be in force and effect on and after January first, nineteen hundred forty-seven.

§ 58-478. **Tax by town where branch located when principal office in county.**—Any incorporated town in this State in which on January first, nineteen hundred and forty-two, was

located a branch bank whose parent bank was at that time located in a county but not in an incorporated town may, by ordinance, require the parent bank to deliver to the assessing officer of such town a copy of the report which such parent bank is required by this chapter to furnish to the commissioner of the revenue of such county and such town may, so long as such condition shall exist, impose a tax not to exceed eighty per centum of the State rate of taxation on each one hundred dollars of the taxable value of the shares of stock in such bank; provided that if such bank has a branch bank in another incorporated town in such county then such other incorporated town may impose a tax not to exceed eighty per centum of the State rate of taxation on each one hundred dollars of the taxable value of the shares of stock in such bank, but such town shall not collect from such tax an amount which exceeds the percentage which the deposits in such branch bear to the deposits of the entire bank as of the beginning of the tax year; provided further that if both such towns impose such tax then the town which first imposed the tax shall continue to collect the entire proceeds of the tax and shall remit to the town subsequently imposing the tax an amount equal to the percentage which the deposits in the branch in the latter town bear to the entire deposits of the bank, including all branches as of the beginning of the tax year. The assessing officers shall extend the tax against the stockholders at the rate levied by the council or other governing body of such towns.

This section as hereby amended shall apply to the tax year nineteen hundred fifty-six and to subsequent years.

§ 58.478.1. **Banks located in counties without the limits of incorporated towns.**—The governing body of any county in which is located a bank without the corporate limits of any town in such county may direct the treasurer of such county, at any time between June first and December thirty-first of any tax year, to file with the State Tax Commissioner an application for the payment to such county of a sum equivalent to eighty

per centum of the amount of tax which such bank has paid into the State treasury for that current tax year on the taxable value of the shares of stock in such bank. The State Tax Commissioner, on receipt of such application, if satisfied of its correctness, shall issue an order directing that such payment be made out of the State treasury on warrant of the Comptroller.

. . This section shall not apply if any such bank has any branch or branches located within the limits of any city or incorporated town anywhere in this State, nor shall it apply if any such bank has any branch or branches located within any county other than the county in which its principal place of business is located. This section shall become effective on January first, nineteen hundred fifty-four.

§ **58-479. Department to audit assessments and correct errors; notice to bank; advice to Comptroller.**—The Department of Taxation shall audit such assessments and shall correct all errors therein and shall notify the bank concerned in each case. The Department shall advise the Comptroller the amount of every assessment made under this chapter, whether made by the commissioner of the revenue or the Department.

§ **58-480. Time and manner of payment by banks of taxes assessed against stockholders; receipts therefor.**—Every bank, on or before the first day of June in each year, shall pay into the State treasury the State taxes assessed against its stockholders and into the treasury of the several cities and incorporated towns in which such banks are located the city and town taxes assessed against its stockholders as in this chapter provided. The treasurer, or other collecting officer, of such city or town shall give to such banks paying city or town taxes duplicate receipts upon forms to be prescribed by the Department of Taxation.

§ **58-481. Credit against State taxes for amounts paid cities or towns.**—Any bank paying for any year the tax herein prescribed assessed by any such city or by any incorporated

town within the State shall be entitled to credit upon the State taxes assessed against its stockholders for that year to the extent of any city or town taxes paid by such bank for that year upon its shares of stock. Such credit shall be allowed by the Comptroller upon the presentation of the duly authenticated receipt of the treasurer or other collecting officer of such city or town. In no event, however, shall the credit for such city taxes exceed forty per centum of the State tax assessed against the stockholders of such bank for that year, nor shall the credit for such town taxes exceed eighty per centum of the State tax assessed against the stockholders of such bank for that year.

§ 58-482. **Collection of taxes assessed against stockholders of banks.**—Should any bank fail to pay the taxes assessed against its stockholders, as provided by this chapter, on or before the first day of June in each year, then, as soon thereafter as practicable, the Department of Taxation shall transmit to the treasurer of the county or city in which the bank is located, the copy of the assessment list furnished it by the commissioner of the revenue and the treasurer shall collect the taxes therein assessed and to this end shall levy upon the stock of the taxpayer or so much thereof as is necessary to pay the taxes and sell the same at public auction for cash as chattels and other personal property are sold under execution. He shall give to the purchaser a bill of sale made under his hand and seal. The bank on presentation by a purchaser of his bill of sale shall cause the stock therein described to be transferred to the purchaser and he shall take a clear and unencumbered title to the stock purchased. Should the taxes assessed against such stockholders be not paid or collected as hereinbefore provided, the lists aforesaid shall stand and be treated and have the legal effect of tax tickets regularly made out against each of the stockholders named in the list as to which tax the right of levy and distress has accrued to the Commonwealth and the treasurer shall proceed to collect the same by levy or distress and possess, all and singular, the authority and power conferred

upon him by law to collect other State taxes.

§ 58-483. **City or town tax; apportionment to other cities or towns where branches are located.**—In the event any city or incorporated town in this State has imposed the tax authorized by this chapter for any tax year and the bank on whose stockholders the tax has been imposed by such city or town has one or more branches located in another city or town or in other cities or towns in this State, the council of the city or town which imposed the tax shall in that year pay each city or town in which any such branch is located a sum equal to forty cents on each one hundred dollars of such proportion of the taxable value of the shares of stock in such bank whose branch or branches are so located in such city or town as the deposits through such branch or branches in such city or town bear to the total deposits of the bank as of the beginning of the tax year.

This section shall be in force and effect on and after January first, nineteen hundred forty-seven.

§ 58-484. **Real estate of banks assessed as other real estate.**—The real estate of all banks shall be assessed on the land books with the same taxes with which other real estate is assessed.

§ 58-484.1. **When bank may omit filing list of taxable stockholders, effect of such omission; when such list must be subsequently filed.**—The foregoing provisions of this chapter are subject to the qualifications contained in this section.

Any bank may for any tax year make a return, on a form prescribed by the Department of Taxation, of the shares of stock issued by it, giving the total number of such shares, the names and residences of the owners of all tax-exempt shares with the number of shares owned by each such tax-exempt stockholder, and such other facts and figures as may be required by the Department of Taxation for an accurate computation of

the actual value of such total number of shares and the actual value of each share, without accompanying such return by a list of the taxable stockholders with their names and residences and the number and actual value of the shares of stock held by each such taxable stockholder; and in such case it shall be deemed that an assessment was made against each taxable stockholder on the taxable value of his shares.

But if any such bank fails to pay the total amount of the taxes due by all its taxable stockholders within the time and in the manner prescribed by this chapter, then such bank shall, not later than the fifteenth day of June of the tax year, file with the Department of Taxation a list, on a form provided by the Department of Taxation, giving the names and residences of all its stockholders and the number and actual value of the shares of stock held by each stockholder; whereupon the Department of Taxation shall proceed to extend the taxes and assess the same against each taxable stockholder in the same manner as the commissioner of the revenue would have been required to do by § 58-473 if this section had not been enacted, and the Department of Taxation shall transmit a copy of the assessment list to the bank, which shall have the effect prescribed by §§ 58-474 and 58-475.

If any assessment of taxes or the liability of any stockholder to taxes under this chapter for any tax year shall become the subject of a proceeding in any court to which the Commonwealth or any political subdivision thereof may be a party, the bank concerned shall file the list mentioned in the next preceding paragraph with the Department of Taxation forthwith on demand made by the Department of Taxation, if such list has not been theretofore filed, whether the bank has paid such taxes or not, whereupon the Department of Taxation shall proceed in the manner set out in the next preceding paragraph and with like effect.

§ 58-485. **Penalty upon bank for failure to comply with chapter.**—Any bank which shall fail or neglect to comply with

any provision of this chapter shall be fined not less than one hundred nor more than five hundred dollars, which fine shall be recovered upon motion, after five days' notice in the circuit, corporation or hustings court of the county or city in which the bank is located. The motion shall be in the name of the Commonwealth and presented by the attorney for the Commonwealth of the court in which the motion is brought or made.

Pertinent amendments to Chapter 10 of Title 58 of the Code of Virginia, effective June 26, 1964:

§ **58-465.2. Meaning of "exempt institution."**—For the purposes of this chapter the term "exempt institution" shall mean any corporation, association or other institution (a) the property of which is exempt from taxation under § 183 of the Constitution of Virginia or under conforming legislation enacted pursuant to it, or (b) an insurance company which pays a State license tax on gross premium income as provided by chapter 11 (§ 58-486 et seq.) of Title 58, and, in either case, which owns the shares of any bank or bank holding company doing business in this State and has informed such bank or bank holding company of its status; but the giving of such information shall not be necessary if such bank or bank holding company has knowledge of the status of such institution; provided that shares of capital stock of any bank holding company held by any such insurance company in excess of ten per cent of the actually issued and outstanding capital stock of any one such bank holding company shall not be deemed to be shares of capital stock of a bank holding company owned by an exempt institution.

§ **58-470.1. Information to be furnished to banks by bank holding company.**—Each bank holding company aforesaid, as of the first day of January in each year, shall notify each bank, any of the capital stock of which it owns, of the total

number of shares of capital stock of such bank holding company then outstanding, the number of such shares owned by exempt institutions, and the name and address of and the number of shares owned by each such exempt institution.

§ 58-470.2. **Bank to include such information in report required by § 58-470.**—Each bank, any of the capital stock of which is owned by a bank holding company, shall include in the report required by § 58-470 the information supplied to such bank by such bank holding company pursuant to § 58-470.1, and such report shall indicate what proportion of the capital stock of such bank holding company is owned by exempt institutions.

§ 58-473. **Rate of taxation of bank stock; assessment; certain shares exempt; to whom lists sent.**—The commissioner of the revenue as soon as he receives the report mentioned in § 58-470 shall assess upon each stockholder upon the taxable value of the shares of stock owned by him a tax at the rate of one dollar on each one hundred dollars of such value of such stock. No such tax shall be assessed in respect to shares owned by exempt institutions or in respect to that proportion of a bank's shares owned by a bank holding company as the number of shares issued by such bank holding company and owned by exempt institutions bears to the total number of outstanding shares of such bank holding company. Such tax shall be in lieu of all other taxes whatsoever for State, county or local purposes upon such share of stock. The commissioner of the revenue shall certify three assessment lists, transmit one to the Department of Taxation, one to the bank and retain one.

§ 58-480.1. **Payments by banks to exempt institutions and bank holding companies held by exempt institutions.**—Each bank, at the time it makes the payments required by § 58-480, shall pay to those of its stockholders which are exempt institutions, or to bank holding companies with stockholders which are exempt institutions, as agents for such stockholders, a

sum equal to the tax which would otherwise have been paid with respect to the shares owned by such exempt institutions or with respect to a proportion of the shares owned by such bank holding company; and every bank holding company receiving any such payment from one or more banks shall pay such sum to those of its stockholders which are exempt institutions in proportion to the number of bank holding company shares owned by each.

§ **58-484.1. When bank may omit filing list of taxable stockholders; effect of such omission; when such list must be subsequently filed.**—The foregoing provisions of this chapter are subject to the qualifications contained in this section.

Any bank may for any tax year make a return, on a form prescribed by the Department of Taxation, of the shares of stock issued by it, giving the total number of such shares outstanding, the names and addresses of all exempt institutions which own its shares or shares of any bank holding company which owns its shares with the number of such shares owned by each exempt institution, the total number of outstanding shares of any such bank holding company and the proportion thereof owned by exempt institutions, and such other facts and figures as may be required by the Department of Taxation for an accurate computation of the actual value of such total number of outstanding shares and the actual value of each share, without accompanying such return by a list of stockholders, except as herein provided; and in such case it shall be deemed that an assessment was made against each stockholder of the bank except an exempt institution and except that in the case of a stockholder which is a bank holding company, such assessment shall not apply to that proportion of the bank's shares owned by such bank holding company as the shares issued by such bank holding company and owned by exempt institutions bears to the total number of outstanding shares of such bank holding company.

But if any such bank fails to pay the total amount of the

taxes due by all its taxable stockholders within the time and in the manner prescribed by this chapter, then such bank shall, not later than the fifteenth day of June of the tax year, file with the Department of Taxation a list, on a form provided by the Department of Taxation, giving the names and residences of all its stockholders and the number and actual value of the shares of stock held by each stockholder; whereupon the Department of Taxation shall proceed to extend the taxes and assess the same against each taxable stockholder in the same manner as the commissioner of the revenue would have been required to do by § 58-473 if this section had not been enacted, and the Department of Taxation shall transmit a copy of the assessment list to the bank, which shall have the effect prescribed by §§ 58-474 and 58-475.

If any assessment of taxes or the liability of any stockholder to taxes under this chapter for any tax year shall become the subject of a proceeding in any court to which the Commonwealth or any political subdivision thereof may be a party, the bank concerned shall file the list mentioned in the next preceding paragraph with the Department of Taxation forthwith on demand made by the Department of Taxation, if such list has not been theretofore filed, whether the bank has paid such taxes or not, whereupon the Department of Taxation shall proceed in the manner set out in the next preceding paragraph and with like effect.

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In the Supreme Court of the United States

OCTOBER TERM, 1971

VIRGINIA NATIONAL BANK, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The memorandum opinion of the district court (Pet. App. 19-27) is reported at 321 F. Supp. 316. The opinion of the court of appeals (Pet. App. 29-35) is reported at 450 F. 2d 1155.

JURISDICTION

The judgment of the court of appeals was entered on November 15, 1971 (Pet. App. 36). A petition for rehearing was denied on December 15, 1971 (Pet. App. 37). The petition for a writ of certiorari was filed on

February 7, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether payments that Virginia law requires petitioner to make to some of its shareholders are nondeductible dividends or are deductible either as ordinary and necessary business expenses under Section 162, or as taxes under Section 164(a) or (c), of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162, 164 and 316 of the Internal Revenue Code of 1954, Sections 1.164-7 and 1.301-1 of the Treasury Regulations on Income Tax (1954 Code), and Chapter 10 of Title 58 of the Code of Virginia of 1950, as amended, are set forth in the Appendix to the petition (Pet. App. pp. 38-61). The pertinent provisions of Sections 301 and 312 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

Petitioner is a national bank doing business in Virginia. Under authority of Revised Statutes, Section 5219, as amended (12 U.S.C. 548), permitting states to levy taxes upon the shares of national banking associations within their limits, Virginia imposes an annual tax (§§ 58-465, *et seq.*, c. 10, Code of Va., 1950, Ann.) upon the stock of national bank shareholders at the rate of one dollar on each one hundred dollars of the stock's value. Some of petitioner's shareholders—

charities and insurance companies—are exempt from the tax. Virginia law (§ 58-480.1, c. 10, Code of Virginia, 1950, Ann.) requires that the banks pay directly to such exempt shareholders an amount equal to the tax that would be assessed against them if they were not exempt.[1] (Pet. App. 20-22, 29-30.)

In accordance with state law, petitioner paid the Virginia tax with respect to those of its shareholders that were subject to it, and also made the payments required by Virginia law to shareholders that were exempt from the tax. During the taxable years in suit (1963-1966), the former payments amounted to more than $1.1 million, and the latter to approximately $36,500. Petitioner did not formally declare a dividend to cover either type of payment. (Pet. App. 22-23.)

On its federal income tax returns for the taxable years, petitioner deducted all of the payments required by state law—both the taxes paid to Virginia and the distributions to tax-exempt shareholders. The Commissioner allowed deductions for the former under Section 164(e) of the Internal Revenue Code of 1954, which permits a corporation to deduct taxes paid by it on behalf of shareholders whose stock interest in a corporation is subject to tax, and further provides that under such circumstances the shareholders shall not be entitled to deductions. He disallowed deductions for

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[1] Prior to 1964, such payments could be turned over to the State, which would then distribute them to the tax-exempt shareholders. A 1964 amendment to the state law did away with the initial transfer to the State, and provided that each national bank make direct payments to those of its shareholders exempt from the state tax. (Pet. App. 22.)

the payments to tax-exempt shareholders on the ground that they were nondeductible corporate distributions to shareholders. Petitioner paid the taxes in dispute, and thereafter brought this suit for refund, claiming that the payments to tax-exempt shareholders were deductible either as taxes under Section 164(a) or (e) or as ordinary and necessary business expenses under Section 162. (Pet. App. 22-23, 30.)

The district court concluded that because the payments to tax-exempt shareholders were made annually and under compulsion of Virginia law, they qualified as ordinary and necessary business expenses under Section 162 (Pet. App. 23-24). It alternatively held them deductible as taxes (Pet. App. 24-27). A divided Fourth Circuit reversed, holding that the payments were nondeductible corporate distributions, and that neither the state law requirements nor the annual nature of the payments made them deductible as ordinary and necessary business expenses or as taxes.[2] (Pet. App. 29-35.)

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review.

1. A distribution by a corporation to its shareholders as such is to be treated as a dividend to the extent of the corporation's post-1913 earnings and profits. Section 301(a) and (c), Appendix, *infra*, pp. 9-10, and Section 316 of the Internal Revenue Code of 1954;

[2] The dissenting judge agreed that the payments were not deductible as taxes, but concluded that ordinary and necessary business expense deductions were warranted (Pet. App. 35).

Treasury Regulations on Income Tax (1954 Code), § 1.301-1(c). Such a distribution is not a cost of doing business,[3] and is not deductible under Section 312(a) of the Code, Appendix, *infra*, p. 10. The nondeductible character of a corporate distribution is not altered by the fact that there is no formal dividend declaration by the corporation,[4] that the distribution is only to certain shareholders,[5] is not intended,[6] or is compelled.[7]

Application of these fundamental rules to the facts of this case requires the conclusion that the payments in question constitute nondeductible corporate distributions within the meaning of the relevant statutory provisions. The payments indisputably were made to the exempt shareholders in their capacity as shareholders, and came from petitioner's earnings and profits. No more is necessary to the resolution of this case.

The court below thus was correct in rejecting petitioner's contention that the requirement of Virginia law that payments be made annually to exempt shareholders somehow converted their character from non-

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[3] *Swed Distributing Co.* v. *Commissioner*, 323 F. 2d 480 (C.A. 5).

[4] *Sachs* v. *Commissioner*, 277 F. 2d 879, 882 (C.A. 8), certiorari denied, 364 U.S. 833; *Hash* v. *Commissioner*, 273 F. 2d 248, 250 (C.A. 4); *Paramount-Richards Theatres* v. *Commissioner*, 153 F. 2d 602, 604 (C.A. 5); *Nickerson Lumber Co.* v. *United States*, 214 F. Supp. 87, 92 (Mass.).

[5] *Sachs* v. *Commissioner*, *supra*, 277 F. 2d at 882; *Hash* v. *Commissioner*, *supra*, 273 F. 2d at 250; *Nickerson Lumber Co.* v. *United States*, *supra*, 214 F. Supp. at 92.

[6] *Sammons* v. *United States*, 433 F. 2d 728, 732 (C.A. 5); *Sachs* v. *Commissioner*, *supra*, 277 F. 2d at 883; *Hash* v. *Commissioner*, *supra*, 273 F. 2d at 250.

[7] *Swed Distributing Co.* v. *Commissioner*, *supra*, 323 F. 2d at 483.

deductible distributions of earnings and profits into ordinary and necessary business expenses. The payments are no less dividends because made regularly. A dividend is the "recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business." *Hellmich* v. *Hellman*, 276 U.S. 233, 237.

Nor does a corporate dividend become a deductible business expense merely because the distributing corporation is required to make it. Many distributions to shareholders are compelled—for example, required dividends on cumulative preferred stock, dividends deemed to have been declared under the foreign personal holding company provisions of the Code (Sections 551 *et seq.*), and dividends paid to avoid the accumulated earnings tax imposed by Section 531 or the personal holding company tax imposed by Section 541. But they are not any the less dividends for that reason. As this Court stressed only last Term in *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, 359, "the fact that a payment is imposed compulsorily upon a taxpayer does not in and of itself make that payment an ordinary and necessary [business] expense within the meaning of Section 162 (a) of the 1954 Code." See also *National Bank of Commerce* v. *Allen*, 223 Fed. 472, 477 (C.A. 8); *Swed Distributing Co.* v. *Commissioner*, 323 F. 2d 480 (C.A. 5).

2. The payments likewise are not deductible as taxes under Section 164(a) or (e). Section 164(a) provides for the deduction of taxes, but only by the taxpayers upon whom they are imposed. See Section 1.164-1(a)(5), Treasury Regulations on Income Tax (1954 Code)

(26 C.F.R.). Virginia law does not impose the tax on national banks but "upon each stockholder * * * of the shares of [such] stock" (other than exempt shareholders). Since no tax is imposed on petitioner, it may not take a deduction under Section 164(a).[8]

Accordingly, the only possible argument for a tax deduction rests on Section 164(e), which permits a corporation to deduct taxes paid by it on behalf of its shareholders upon whom a tax is imposed. But, as the court below recognized (Pet. App. 34), petitioner did not pay taxes for its tax-exempt shareholders. It merely distributed corporate earnings to them. Section 164(e), as its legislative history indicates (see S. Rep. No. 275, 67th Cong., 1st Sess., p. 19), is designed to permit a corporation to deduct taxes that otherwise would be deductible by shareholders. Since the tax-exempt shareholders were not taxed, and therefore were not entitled to a tax deduction, there is no deduction that could be transferred to petitioner under Section 164(e).

3. Petitioner devotes considerable argument (Pet.

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[8] This is true not only for the payments to exempt shareholders, but also for the actual taxes paid to Virginia with respect to the shares of nonexempt shareholders. Deduction of the latter payments is allowed only under Section 164(e), which artificially permits the deduction of the payments as if the corporation had paid the taxes on its own behalf. See *Porter* v. *United States*, 27 F. 2d 882, 885 (C.A. 9); *First Nat. Bank of Jackson, Miss.* v. *McNeel*, 238 Fed. 559 (C.A. 5); *National Bank of Commerce* v. *Allen*, 223 Fed. 472 (C.A. 8); *Eliot Nat. Bank* v. *Gill*, 218 Fed. 600 (C.A. 1); Art. 566 of Treasury Regulations 45 (1920 ed.); T.D. 1763, 15 Treasury Decisions, Internal Revenue 25 (1912). See also I.T. 1300, I-1 Cum. Bull. 11 (1922); *Bank of Mount Hope* v. *Commissioner*, 25 B.T.A. 542. Compare Rev. Rul. 70-293, 1970-1 Cum. Bull. 282, 283.

11-15) to the question whether Virginia may compel national banks to make distributions. Whatever the answer may be to that question, it has no bearing on the tax issue presented here. The question of Virginia's power to compel distributions could properly be raised only in a case where a national bank or a shareholder challenged the Virginia statute. That is not this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis.*—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis.*—

(A) *In general.*—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) *Distributions out of increase in value March 1, 1913.*—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value

accrued before March 1, 1913, shall be exempt from tax.

* * * * * *

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) *General Rule.*—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property, so distributed.

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